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# APPRAISALS AND FEDERAL TAX PROCEDURE

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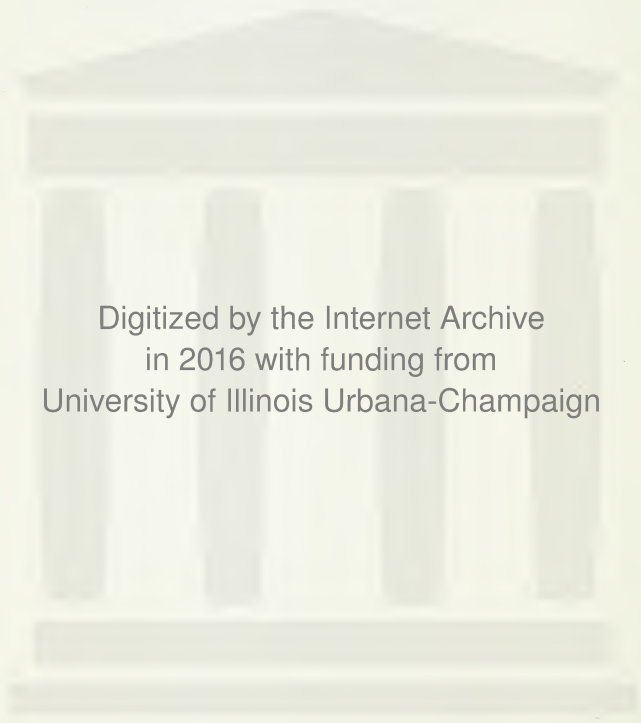
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# Appraisals and Federal Tax Procedure

A Reference Work

Defining the Use and Preparation of  
Appraisals Made to Conform with  
Government Requirements  
on Income and Excess  
Profits Tax Laws



Compiled by

The American Appraisal Company

New York — Milwaukee

1922

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## Foreword

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**T**HOUGH the use of authoritative appraisal service in meeting certain requirements of the income tax has long been recognized by many students of taxation, there has never been a definite explanation and index to the passages of the law, the regulations, rulings, and recommendations by which the Government has sought to define and control the application of appraisals to taxation.

It is therefore the purpose of this booklet to summarize the development of the federal laws as they affect appraisals, and to explain and cite excerpts from official literature governing appraisals. It is hoped that this will provide the taxpayer, the accountant, or the attorney with readily usable facts as presented by the Government itself, with only such interpolated explanation as may be necessary to supplement the quotations in indicating the possibilities which properly prepared appraisals present to the taxpayer in securing an equitable adjustment of tax difficulties.

THE AMERICAN APPRAISAL CO.





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## CHAPTER I

### Development of Retrospective Appraisals

THE passage of the 1909 corporation tax law was the forerunner, and the constitutional amendment on income taxation was the opening wedge of a new theory and practice in the appraisal field.

The first influence was the incentive which it gave the taxpayer to establish correct property values and annual rates of depreciation for the purpose of computing the depreciation exemptions from taxable income. There had not been such a change in market values at that time as to force the consideration of the difference between investment based upon original cost and investment based upon the cost of reproduction.

With the increase in the rate of taxation, the emphasis upon the depreciation exemption was increased and the taxpayer gave more thought to his plant accounts. More consideration was also given to the increasing divergence between original costs and reproduction costs.

As a result, a minority report of the Committee on Federal Taxation of the National Tax Association, presented at San Francisco in 1915, recommended that "the basis from which profit or loss is reckoned should be the fair value of the property at the time the law went into effect and *not* the original cost." This idea later was incorporated into the Act of September 8, 1916, and Regulations 33, revised. The same Regulations had the provision that depreciation was to be computed on the value of property as of March 1, 1913.

The benefits resulting to owners and operators of natural resources through the use of March 1 values in place of actual costs of property acquired prior to March 1, 1913, were of greater advantage than they were to the owners of property subject only to depreciation charges. Natural resources are generally purchased at nominal costs and the values are created through exploration and development, so that the March 1, 1913, values quite generally exceed the actual cost, including the cost of exploration and development of the property.

The enactment of the 1917 Revenue Law introduced a new and most controversial problem in connection with the statutory Invested Capital. The exemption from taxable income on the basis of capital invested in the business was economically sound and made legitimate a desirable exemption to the taxpayer requiring an investment in proportion to the return in profit.

The practical application of this, however, revealed the alarming extent to which the books of account did not correctly reflect the investment in the business. The law was apparently framed with the idea that the books of account did reflect the invested capital or could readily be reconstructed on a basis that would do so.

Many taxpayers in the past had not kept complete property records due to conservative practice in understating their capital accounts and the fact that the owners were in direct personal control and had first-hand information as to the statement of the property and the business, which in their minds made it unnecessary to preserve an accurate and detailed accounting of their property investment.

The law, however, only specifically recognizes that "A corporation's books of account will be presumed to

show the facts," and the burden of proof for the correction required rests upon the taxpayer. Little direct emphasis was made upon the fact that the property owned and in existence during the several taxable years was the prime evidence of the actual invested capital in the properties for such concerns.

The demands of the government on account of the World War and the enactment of the prohibition amendment injected other elements. Many taxpayers suffered a loss on account of the additional capital required to develop and expand their properties for war production and which had a diminished value for use in connection with the normal post-war requirements. A loss resulted to the producers of alcoholic beverages on account of prohibition through the diminished utility of their property. Some sold their properties, and therefore realized their loss, while others converted them to other uses or maintained them for the manufacture of non-intoxicating drinks, or let them remain entirely inactive.

We, therefore, had a varied class of conditions in which the investment in, the value at date of acquisition, or as of March 1, 1913, and the present condition and remaining serviceable life and value of properties became important factors, in case the property accounts furnished only incomplete and inadequate evidence. In order to determine the correct facts, it was necessary to check the accounts against the properties themselves.

### What Was an Appraisal?

What was this service that worked from the properties themselves? There had been a popular opinion that an appraisal was synonymous with the determination of

current values. This definition of an appraisal was too narrow a construction to meet the tax requirements and a more correct definition in accordance with the actual use of appraisals was that an appraisal is a service which works from the properties themselves in the determination of any fact in reference to their investment, value, utility, or usefulness.

For the purpose of the provable evidence required by the Treasury Department, it was also necessary to distinguish between "opinion values" and "appraised values." By opinion values is meant those values based upon the personal opinion of an individual and arrived at in accordance with his experience and best judgment. Such a valuation has a legitimate use and may be of greatest accuracy. It must, however, be accepted on the authority of, and confidence in, the individual and is not, generally speaking, capable of proof. By appraised values we refer to a valuation arrived at under the personal supervision of thoroughly qualified executives, whose skilled judgment is the result of many years' experience in valuation work, who have the assistance of trained appraisers using organized cost analysis records, statistical data, and guided by checks of definite, predetermined, and tested standards of valuation. It is an executive organization using established methods and records which insure the testing of appraised valuations against well-established standards and guarantee their uniformity and provability. The test of an appraisal organization is the extent to which it has reduced valuation work to an exact science.

## Appraisals Applied to Income Tax Requirements

The appraisal organization during this period had been developing and adjusting its practice to conform with the Regulations of the Treasury Department and decisions of the Internal Revenue Division and the courts. However, as the importance of the appraisal service and the vital character of the adjustments between the taxpayer and the government became evident the Department grew critical and skeptical in reference to the use of appraisals. This was largely the result of the unsatisfactory appraisal work submitted to the Department and the incorrect use of appraisals. The Department, therefore, endeavored to protect itself against the use of appraisals by a too literal interpretation of the law and regulations in reference to books of account. The Department went further than this in theoretical adjustments of the accounts without regard to actual facts as evidenced by the properties themselves.

In this the Department was wrong, in that the law went no farther than to state that the books of account should be considered as representing the facts and that the burden of proof for any adjustments in the accounts rested upon the taxpayer. Many of the adjustments and corrections in the accounts required or permitted by the law could only be made upon the evidence gained from the properties themselves. The revenue laws require or permit the taxpayer to adjust his property accounts in the following respects:

1. To determine the investment in the property existing during each of the taxable years.
2. To determine the cost of the property as of the date of acquisition.



3. To determine the value of the property as of the date of reorganization.
4. To restore to investment, property having a useful life extending beyond the year in which the expenditure was made which had been charged to current expense.
5. To correct the investment for property discarded and improperly recorded on the books of account.
6. To compute depreciation on the basis of the fair market value of property in existence on March 1, 1913, in distinction from computation on the basis of original investment.
7. To have depreciation charges take into consideration the renewals and betterments tending to offset depreciation.
8. To establish or adjust depreciation charges to conform with the remaining expectancy of life of the property units.
9. To compute depletion and depreciation on the basis of March 1, 1913, values for deposits, construction, and equipment used exclusively in connection with depletion operations subject to the remaining life of the deposit and the salvage value of the construction and equipment upon the exhaustion of the deposit.
10. To compute profit or loss on the sale of property on the basis of values as of March 1, 1913, for property existing at that time, plus actual costs for subsequent additions properly depreciated to the date of the sale.
11. To establish the amortization allowance in accordance with the value of the property in use.
12. To determine the remaining value of properties designed, constructed, and equipped for the manufacture of alcoholic beverages in accordance with conditions existing under the provisions of prohibition legislation.



This involves an historical investigation of the accounts and properties and the physical and business conditions affecting their present utility and remaining serviceable life.

With the practical application of the tax laws through actual business problems and transactions, many unexpected problems of valuation arose, involving valuation for purposes of depreciation and for the purpose of determining profit and loss on sale of patent rights, leases, contracts, good will, and various forms of intangible values. Every factor that entered into the determination of value or influenced men's minds in connection with the asking or the purchase price in the sale or transfer of property, entered into the value for taxation purposes.

In connection with prior appraisal work these values had to be considered but this had usually been in connection with current markets; now these values were to be determined as of a prior date, March 1, 1913, date of reorganization, or date of original acquisition.

Following a practice in the Internal Revenue Department which had been negative or non-committal, and decisions by the Committee on Appeals and Review that had been to a certain extent contradictory and to a minimum extent recognized only the practical side of the situation, the Committee on Appeals and Review early in 1921 eased the situation to a certain extent through Memorandum 106. All this was supplemented later by a statement in July and a further order by the Commissioner in November, known respectively as C. B. 5-1748 and O. D. 1104: C. B. 5-1926. A more complete recognition of the situation, however, was made in the Committee on Appeals and Review Recommenda-

tion 747 which covers the general growth and application of retrospective appraisals, and in Treasury Decision 3367 which recognizes and defines retrospective appraisals more particularly in relation to their application to the determination of paid-in surplus as provided for under Article 836 of Regulations 62. (See pages 53-63 for the text of these decisions.) Other decisions bearing direct reference to the use of retrospective appraisals under other articles of the Regulations, may be expected.

### The American Appraisal Company

During this period The American Appraisal Company had been a pioneer and a constructive agency in the application of appraisal service to meet these new requirements, and in bringing the attention of the Treasury Department and taxpayer to the correct use and application of appraisal service.

These problems had come up in its practice during the earlier years in which the income tax laws were in effect and with the more radical changes and provisions in the 1917 law, they had prepared a number of articles on appraisals in relation to income tax requirements which appeared in the *American Appraisal News* and were later printed in pamphlets widely distributed to clients, associations, and business prospects.

Little, if any, controversy in reference to the principle developed at first. One of the earlier and more important causes leading to the misunderstanding and divergence in points of view was the result of action taken by the Tanners Council, of the National Association of Tanners, which on December 12, 1917, issued "Circular Number 6" to all of the members, advising

them to have appraisals made in accordance with the standard practice of appraisal companies for the determination of current sound values, to have these entered upon their books and to report these findings as invested capital in their income tax returns. This statement was so widely distributed and so contrary to the intent of the revenue act that the Treasury Department issued a statement, that "appraisals made in accordance with current values were not acceptable as a basis for determining invested capital." This was an entirely correct statement, but was quite generally misquoted and misinterpreted to the effect that appraisals were not acceptable as a basis for determining invested capital.

It was events of this kind and repeated misuse of appraisals resulting in a divergence of opinion and a negative attitude in the Treasury Department which culminated in the controversial and uncertain condition existing in 1921. In the meantime The American Appraisal Company had been perfecting its records and adapting its practice to meet the requirements of the revenue acts, regulations and decisions as it interpreted them. In connection with its appraisal practice it came in contact with the leaders of industries, accountants, tax advisors, lawyers and officials in the Revenue Department and by example and precept illustrated the correct technic and application of appraisal service to these new requirements.

In the spring of 1921 at the Regional Convention of the American Institute of Accountants, Mr. Lyle H. Olson, Vice-President of The American Appraisal Company, gave a talk on appraisals in relation to income tax requirements which was published in the July issue of the *Journal of Accountancy* and was discussed quite

widely by income tax authorities without and the officials within the Internal Revenue Department.

As a corollary to The American Appraisal Company's development of the procedure necessary for the preparation of appraisals to meet with its interpretation of the law and regulations, it at the same time created, educated, and adapted its organization, and accumulated records to meet the new problems.

This organization has been an important factor in bringing the taxpayers, the income tax specialists, and the officials of the Internal Revenue Department to recognize the proper scope of appraisal service and the application of it to their needs, and in calling attention to the reconstruction work that will be necessary to bring property records in line with the requirements of the revenue laws, regulations and decisions.

Evils may have resulted from the application of this new principle of taxation in such an abnormal period as was created by the war with the resultant fluctuations in property values, abnormal economic conditions, and dislocations in property utility. But it has been and will continue to be a constructive force in business that will cause property records to be established and maintained to reflect the investment correctly and will force the valuation and depreciation of properties to be in accordance with the actual facts. It will promote better and sounder business conduct, accounting, and financing.

The business of the future should benefit by the painful adjustments which are taking place today. The promoter, the banker, and the investor may place a greater reliance upon statements of property investment, values, and utility when they are reported by retrospective and current value appraisals.

## CHAPTER II

### Determination of Gain or Loss

**Purpose of Appraisal:** To determine the March 1, 1913, value of property remaining from that date, the cost of all capital items acquired since, and the accrued depreciation, as a means of establishing the amount of gain or loss resulting from the sale or exchange of properties.

#### Law

SECTION 202, REVENUE ACT OF 1921.

(a) That the basis for ascertaining the gain derived or loss sustained from a sale or other disposition of property, real, personal, or mixed, acquired after February 28, 1913, shall be the cost of such property; except that \* \* \* (*The following tabulation is a paraphrase of the law. See Sec. 202 for specific details.*)

1. On inventoried property, the basis shall be the last inventoried value.
2. On property acquired by gift after December 31, 1920, the basis shall be the same as that which it would have been in the hands of the donor. Or, if acquired by gift prior to December 31, 1920, the basis shall be the fair market value at the date of acquisition.
3. On property acquired by bequest, devise, or inheritance, the basis shall be the fair market value at the date of acquisition.



(b) The basis for ascertaining the gain derived or loss sustained from the sale or other disposition of property, real, personal, or mixed, acquired before March 1, 1913, shall be the same as that provided by subdivision (a); but—

1. If its fair market price or value as of March 1, 1913, is in excess of such basis, the gain to be included in the gross income shall be the excess of the amount realized therefor over such fair market price or value;
2. If its fair market price or value as of March 1, 1913, is lower than such basis, the deductible loss is the excess of the fair market price or value as of March 1, 1913, over the amount realized therefor; and
3. If the amount realized therefor is more than such basis but not more than its fair market price or value as of March 1, 1913, or less than such basis but not less than such fair market price or value, no gain shall be included in and no loss deducted from the gross income.

(c) *These subdivisions deal with the determination of*  
(d) *gain or loss on the exchange of property. The*  
(e) *application of an appraisal is so occasional that it is not thought practical to quote them here. See Section 202 of the Revenue Act of 1921.*

## Regulations

ARTICLE 1561, REGULATIONS 62.—*Basis for determining gain or loss from sale.*

For the purpose of ascertaining the gain or loss from the sale or exchange of property, the basis is the cost of such property, or in the case of property which should be included in the inventory, its latest inventory value. But in the case of property acquired before March 1, 1913, when its fair market value as of that date is in

excess of its cost, the gain to be included in gross income is the excess of the amount realized therefor over such fair market value. \* \* \* What the fair market value of property was on March 1, 1913, is a question of fact to be established by any evidence which will reasonably and adequately make it appear.<sup>1</sup>

### Rulings

O.D. 955. Bulletin: 26-21-1699.

What the fair market value of the property was at that time [February 28, 1913] is a question of fact to be established by any appropriate evidence which is available. Among other things there may be submitted as evidence of such value the sales price of like property in sales occurring in the same locality at that time and an appraisal made by a disinterested person familiar with real-estate values in the locality and with conditions affecting such values at that time.

A. R. R. 272. Bulletin: 40-20-1223.

The second question is as to the method of determining the value on March 1, 1913, of this equipment. It is manifest that the taxpayers and the Bureau must

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<sup>1</sup> "Where plant property is acquired and later sold for a higher price, the gain on the sale is income. If, however, the property was acquired before March 1, 1913, only such portion of the gain as accrued subsequent to February 28, 1913, is taxable by the Federal Income Tax. For this purpose, therefore, the appraisal should be on the basis of March 1, 1913, prices for property remaining from that date, and at actual costs for later additions,

and reduced by the amount of any charges for depreciation, depletion and other losses. As all plant properties are subject to sale in whole or in part at any time it is a wise precaution to have values as of March 1, 1913, established now so that one may be prepared to estimate the taxable profits on a proposed sale at the time the sale is under consideration." (*Appraised Values*, a booklet published by The American Appraisal Company in 1919.)

constantly engage in the valuation of properties owned on March 1, 1913, for the purpose of determining profit or loss on the sale thereof, and it is the consistent rule to fix such values, even though no appraisals were made on or about March 1, 1913, by the best evidence which can be arrived at, and upon "any evidence which will reasonably and adequately make it appear." The method used by the appraisal company was to ascertain from data in their possession, the reproduction cost on March 1, 1913, of equipment under consideration and to accept that, less depreciation from original acquisition, as the true value of that date. This appears to the Committee to be a fair and reasonable method of determining value of equipment and to establish such value as nearly as it is possible now to do. In the absence of any evidence, therefore, showing that the values so established were not fair values as of that date, the Committee recommends their acceptance.<sup>2</sup>

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<sup>2</sup> "The reconstruction of the pattern account properly required a more painstaking investigation than the building and equipment accounts. You have the questions of depreciation, obsolescence inactivity, one pattern succeeding another pattern, models may have been changed, cost records are incomplete as to the cost of each individual pattern or the individual group of patterns. It is, therefore, desirable to make an analysis of the entire pattern department expense or the drawing

room expense, by years, and to judge what portion of that might be reasonably expected to be capitalized. Then tie that with the cost of the patterns made during the respective years, priced in accordance with the normal prices for each year, as proven by an appraisal of the actual active patterns, balancing them together in order to complete your proof." (Lyle H. Olson, Vice-President of The American Appraisal Company in *The Journal of Accountancy* for July, 1921.)



## CHAPTER III

# Depreciation of Physical Properties

**Purpose of Appraisal:** To determine the value of depreciable assets as the March 1, 1913, value of all property then in existence, subsequent deductions, costs of subsequent additions, and the proper rate of depreciation to be applied.

## Law

SECTION 214 (a)8, REVENUE ACT OF 1921.

That in computing net income there shall be allowed as deductions:

A reasonable allowance for the exhaustion, wear and tear of property used in the trade or business, including a reasonable allowance for obsolescence. In the case of such property acquired before March 1, 1913, this deduction shall be computed upon the basis of its fair market price or value as of March 1, 1913.<sup>1</sup>

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<sup>1</sup> "The preparation of a report on values now, but as of March 1, 1913, comprises the listing, describing, and classifying of property in much the same manner as for invested capital purposes, but that part proven to have been in existence prior to or at March 1, 1913, may be valued in accordance with market conditions at that date. In such cases as this,

where value exceeds costs, depreciation computed on it will, of course, be higher than if based on costs, and the authenticity of the records and the reputation of the organization supporting such a value must be subject to such test as the department may require." (H. B. Hall of The American Appraisal Company in *Brick and Clay Record* for Dec. 27, 1921.)

## Regulations

### ARTICLE 1561, REGULATIONS 62. *Basis for Determining Gain or Loss from Sale:*

What the fair market value of property was on March 1, 1913, is a question of fact to be established by any evidence which will reasonably and adequately make it appear.

## Rulings

T. B. R. 57.

Bulletin 19-19-494.

Frequently excellent evidence as to the "fair market value" of property, especially that which, though not ordinarily traded in, has a value in use, is found in its cost, or in the cost of reproducing it, with adjustments for depreciation and the like. (It should be noted, however, that while cost is frequently excellent evidence of "fair market value," "fair market value" may be either greater or less than cost and must, wherever made the statutory test, be taken regardless of its relation to cost.)

### BULLETIN "F" (PAGE 4) BUREAU OF INTERNAL REVENUE.

The rate [of depreciation] applicable and the adjustment of any case must depend upon the actual conditions existing in that particular case.<sup>2</sup>

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<sup>2</sup> Depreciation is a very real thing, a fact and not a theory. It represents the actual decrease in value of property resulting from age, wear and tear, or other causes due to conditions of use, hours of operation, exposure, conditions of maintenance, care of at-

tendants, lack of utility, obsolescence, and many other causes and it is possible to measure it with a very fair degree of accuracy and in a scientific manner." (*Getting the Facts*, booklet published by The American Appraisal Company in 1920.)

BULLETIN "F" (PAGE 20) BUREAU OF INTERNAL REVENUE.

Allowances for depreciation may under no circumstances be based on a fictitious cost price or value of property, or on its replacement value. If property was acquired prior to March 1, 1913, and its fair market value as of that date forms the basis for computing the allowance for depreciation and obsolescence, such value must be substantiated by evidence satisfactory to the Commissioner. No appraised value as of any date other than March 1, 1913, may be used as the basis for computing the allowance.<sup>3</sup>

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<sup>3</sup> A brief example may here serve to illustrate the advantage of having an accurate and provable determination of property values as of March 1, 1913: "A erects an office building in 1908 at a cost of \$540,000, its estimated useful life being 50 years. The annual charge for depreciation would be \$10,800. The fair market value of the building March 1, 1913, substantiated by proper

evidence is \$540,000. This amount may be spread ratably over the remaining useful life of the property, 45 years, and \$12,000 charged off each year until the full amount of \$540,000 has been charged off irrespective of the fact that over \$50,000 will have been charged off prior to 1913." (Page 19 *Bulletin "F"* of the Internal Revenue Department.)

## CHAPTER IV

### Depletion of Natural Resources

**Purpose of Appraisal:** To determine the value or cost, as may be required, of the resources to be depleted, the rate of depletion, and the amount deductible as depletion for each taxable year.

#### Law

SECTION 214 (a) 10, REVENUE ACT OF 1921:

That in computing net income there shall be allowed as deductions:

In the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case, based upon cost including cost of development not otherwise deducted: *Provided*, That in the case of such properties acquired prior to March 1, 1913, the fair market value of the property (or the taxpayer's interest therein) on that date shall be taken in lieu of cost up to that date: *Provided further*, That in the case of mines, oil and gas wells, discovered by the taxpayer, on or after March 1, 1913, and not acquired as the result of purchase of a proven tract or lease, where the fair market value of the property is materially disproportionate to the cost, the depletion allowance shall be based upon the fair market value of the property at the date of the discovery, or within thirty days thereafter.

## Regulations

### ARTICLE 210, REGULATIONS 62. *Computation of Deduction for Depletion of Mineral Deposits:*

(b) When the value of the property at the basic date has been determined, depletion sustained for the taxable year shall be computed by dividing the value remaining for depletion by the number of units of mineral to which this value is applicable, and by multiplying the unit value for depletion, so determined, by the number of units sold or produced within the taxable year.

### ARTICLE 206(A), REGULATIONS 62. *Determination of Fair Market Value of Oil and Gas Properties:*

(a) Where the fair market value of the property at a specified date in lieu of the cost thereof is the basis for depletion and depreciation deductions, such value must be determined, subject to approval or revision by the Commissioner, by the owner of the property in the light of the conditions and circumstances known at that date, regardless of later discoveries or developments in the property or subsequent improvements in methods of extraction and treatment of the oil and gas product. The value sought should be that established, assuming a transfer between a willing seller and a willing buyer as of that particular date. The Commissioner will lend due weight and consideration to any and all factors and evidence having a bearing on the market value, such as

Cost,

Actual sales and transfers of similar properties,<sup>1</sup>

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<sup>1</sup> "The difficulty is that most profitable mining properties have not changed hands since March 1, 1913. In a considerable number of oil properties, valuation

must be made after that date, where there has been no change of ownership, but a 'discovery' value was claimed. Actual sales are often not a criterion. The

Market value of stock or shares,  
 Royalties and rentals,  
 Value fixed by the owner for purpose of the capital stock tax,<sup>2</sup>  
 Valuation for local or State taxation, partnership accountings,  
 Records of litigation in which the value of the property was in question,  
 The amount at which the property may have been inventoried in probate court, and, in the absence of better evidence,  
 Disinterested appraisals by approved methods.<sup>3</sup>

Where the fair market value must be ascertained as of a certain date, analytic appraisal methods, such as the present value method, will not be used if the fair market value can reasonably be determined by any other method.

(b) To determine the fair market value of an oil and/or gas property by the present value method, the

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author knows of a mine which was sold recently at a price very much above what similar properties in the same district had sold for. The purchaser, however, basing his action on a different operating policy than was used in the district, and on more intensive exploration work, believed the property worth considerably more than the price at which similar properties had changed hands, and backed up his belief by purchase." (Montgomery's *Income Tax Procedure*, 1922, page 1176.)

<sup>2</sup> "The connection of the capital stock tax law with fair values of minerals on March 1, 1913, is remote, to say the least, in view of the fact that the first report under the capital stock tax law was not

due until 1917." *Ibid*, page 1176.)

<sup>3</sup> "It is a matter of common knowledge that in the case of mines and oil and gas wells, and to some extent as to timber, many of the ordinary evidences of value are not good criteria, as properties are not similar, and the value of one does not indicate the value of its neighbor. Of two adjacent mines one may be worth millions and the other be a liability; of two adjacent wells, one may be a gusher and the other dry; one timber lot may be first-growth pine, and the adjoining one second-growth hardwood." (R. V. Norris, *The Taxation of Income from Wasting Assets*.)

"The appraisal method should include investigation of every fac-



essential factors must be determined for each deposit included in the property. The factors are:

1. The total quantity of oil and gas in terms of the principal or customary unit (or units) paid for in the product marketed,
2. The average quality or grade of the oil and gas reserves,
3. The expected percentage of extraction or recovery in each process or operation necessary for the preparation of the oil and gas for market,
4. The probable operating life of the deposit in years,
5. The unit operating cost, i.e., cost of production exclusive of depreciation and depletion, and
6. The rate of interest commensurate with the risk for the particular deposit. When the deposit has been sufficiently developed these factors may be determined from past operating experience. In the application of factors derived from past experience full allowance should be made for probable future variations in the rate of exhaustion, quality or grade of the oil and gas, percentage of recovery, costs of production, interest rate, and selling price of the product marketed during the expected operating life of the oil and gas deposit.

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tor bearing on 'fair market value,' including actual sales, holding prices, utility, etc., and any such information as is available should be in harmony with or reconciled to any value established by 'analytic appraisal methods.' " (Standard Instructions of The American Appraisal Company.)

"American Appraisals establish values through a careful analysis and consideration of every factor influencing values; value of improvements; age of production; past production records; state of

development of lease; location of property in respect to other producing properties; thickness and nature of oil producing sands; probability of deeper sands not yet explored; depth to which additional wells would be drilled; the probable cost of lifting oil; salvage value of equipment on developed leases; existing market conditions in the oil industry." (*Appraisals for the Oil Industry*, booklet published by The American Appraisal Company in 1921.)

## CHAPTER V

### Loss of Useful Value

**Purpose of Appraisal:** To determine the March 1, 1913, value of all property remaining from that date, the cost of subsequent additions, and the remaining value left to such assets abandoned through the enforcement of prohibition legislation, or other unforeseen cause; or to determine the gradual reduction in the value of such assets due to the normal progress of industry.

#### Law

SECTION 214 (a)4, REVENUE ACT OF 1921:

That in computing net income there shall be allowed, as deductions:

Losses sustained during the taxable year and not compensated for by insurance or otherwise, if incurred in trade or business.

#### Regulations

ARTICLE 143, REGULATIONS 62. *Loss of Useful Value:*

When, through some change in business conditions, the usefulness in the business of some or all of the capital assets is suddenly terminated, so that the taxpayer discontinues the business or discards such assets permanently from use in such business, he may claim as a loss for the year in which he takes such action the difference between the cost, or, if acquired prior to March



1, 1913, fair market price or value as of that date of any assets so discarded (less any depreciation sustained and allowable as a deduction in computing net income) and its salvage value remaining. This exception to the rule requiring a sale or other disposition of property in order to establish a loss requires proof of some unforeseen cause by reason of which the property has been prematurely discarded, as, for example, where an increase in the cost of or other change in the manufacture of any product makes it necessary to abandon such manufacture, to which special machinery is exclusively devoted, or where new legislation directly or indirectly makes the continued profitable use of the property impossible.<sup>1</sup>

### Rulings

O. D. 125.

Bulletin: 3-19-190.

Property consisting of a plant, including equipment for the manufacture of beer bottles, which because of restrictions and regulations by the United States Government on the brewery industry can not be sold and in consequence the factory had to be closed, has, to the extent the property or plant was constructed for the manufacture of beer bottles and is not suited or adapted for any other purpose without reconstruction, become obsolete. The corporation to that extent is entitled to a deduction for obsolescence.

<sup>1</sup> "Where property has lost its usefulness through change in business conditions, such property should be inventoried, full investigation made of the conditions resulting in such loss, the present and prospective usefulness of such property in connection with the trade or business, or its sale or salvage value, and the resulting loss determined as the difference between:

1. The fair market value as of March 1, 1913, for property acquired prior to that date plus the costs of subsequent additions, less deduction for ordinary depreciation; and
2. The useful value of such property under the conditions stated." (Standard Instructions of The American Appraisal Co.)

O. D. 1001

Bulletin: 34-21-1780

In order that a taxpayer may be allowed a deduction for obsolescence for any given period, it is essential that the use of the property should have been abandoned during such period or that it become certain that the property must be abandoned at a definite future date. Therefore, where the use of property is continued in a related enterprise under the same ownership, there is no abandonment, nor is it possible to say at the time of conversion that the property must be abandoned.

O. D. 381

Bulletin: 4-20-704

The figure representing obsolescence should be, approximately, the difference between the fair market value of the building as of March 1, 1913, or its cost if acquired after that date, less depreciation, and the estimated salvage value.

T. B. R. 44

Bulletin: 15-19-445

Distillers and dealers in liquors are entitled to make a deduction (based upon actual cost or fair market value as at March 1, 1913) from gross income, on account of depreciation or obsolescence of their intangibles, such as good will, trade-marks, trade-brands, etc., such deductions being limited to assignable assets, the value of which has been destroyed by prohibition legislation.<sup>2</sup>

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<sup>2</sup> "Good will is a live problem. Many firms have their good will reconstructed in accordance with March 1, 1913, values. Some times it may be purely an accounting proposition; at other times, it involves an appraisal problem relating to the character of the business, its mechanical operations,

its markets, its future; and requires investigations to supplement the service which the accountant would render." (Lyle H. Olson, Vice-President of The American Appraisal Company in *The Journal of Accountancy* for July, 1921.)

## CHAPTER VI

### Amortization of War Properties

**Purpose of Appraisal:** To determine the actual cost, the depreciation and losses on, and the normal post-war value of all properties acquired during the war with Germany for the production of articles contributing to the prosecution of that war, which through the cessation of the war demand were over-adequate, and from this the amount to be amortized.

#### Law

SECTION 214 (a)9, REVENUE ACT OF 1921:

That in computing net income there shall be allowed as deductions:

In the case of buildings, machinery, equipment, or other facilities, constructed, erected, installed, or acquired, on or after April 6, 1917, for the production of articles contributing to the prosecution of the war against the German Government, and in the case of vessels constructed or acquired on or after such date for the transportation of articles or men contributing to the prosecution of such war, there shall be allowed, for any taxable year ending before March 3, 1924 (if claim therefor was made at the time of filing return for the taxable year 1918, 1919, 1920, or 1921) a reasonable deduction for the amortization of such part of the cost of such facilities or vessels as has been borne by the taxpayer, but not again including any amount otherwise

allowed under this title or previous Act of Congress as a deduction in computing net income. At any time before March 3, 1924, the Commissioner may, and at the request of the taxpayer shall, re-examine the return, and if he then finds as a result of an appraisal or from other evidence that the deduction originally allowed was incorrect, the income, war-profits, and excess-profits taxes for the year or years affected shall be redetermined; and the amount of tax due upon such redetermination, if any, shall be paid upon notice and demand by the collector, or the amount of tax overpaid, if any, shall be credited or refunded to the taxpayer in accordance with the provisions of Section 252.<sup>1</sup>

## Regulations

### ARTICLE 184, REGULATIONS 62. *Computation of Amortization Allowance:*

The total amount of the amortization allowance is the difference between the original cost of the property if constructed, erected, installed, or acquired on or after

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<sup>1</sup> "The third purpose — that of amortization — involves the segregation of property added for war purposes subsequent to April 6, 1917. This we should receive from the accountant with the actual cost, segregated in such a manner that it may be checked against the property acquired.

"The amount of amortization is determined for two classes of properties: That which has been or is to be abandoned, and that which will remain in the service of the company.

"For that which has been abandoned, it is, of course, a mat-

ter for the accountant to determine the difference between the investment and the selling price (if it has been sold) or possibly for the appraiser, if the salvage value is to be determined. However, the second division, which concerns itself with the useful value of property retained to the industry, involves a consideration of a number of facts in reference to the normal post-war conditions of that particular business." (Lyle H. Olson, Vice-President of The American Appraisal Company, in *The Journal of Accountancy*, July, 1921.)

April 6, 1917; or if acquired partly before and partly after April 6, 1917, then that part of the cost incurred on or after April 6, 1917, and properly entered on the books of the taxpayer on or after that date, less any amounts deducted for depreciation, losses, etc., prior to January 1, 1918, and the value of the property on either of the bases indicated below:

1. In the case of property which has been sold or permanently discarded, or which will be sold or permanently discarded before March 3, 1924, the value shall be the actual sale price or estimated fair market value as of the date when the property was or will be permanently discarded plus a reasonable allowance for depreciation in case the property is used in the taxpayer's business after the close of the amortization period. Such fair market value shall be established by investigation of engineers of the Bureau of Internal Revenue, if such investigation is deemed advisable.
2. In the case of property not included in (1) above, the value shall be the estimated value to the taxpayer in terms of its actual use or employment in his going business, such value to be not less than the sale or salvage value of the property and not greater than the estimated cost of replacement under normal post-war conditions less depreciation and depletion<sup>2</sup>. Upon the basis of the costs prevailing at the latest prewar date at which a reasonably normal market existed, the Commissioner shall in respect of basic material and labor costs determine and publish ratios of estimated post-war costs of replacement, and a taxpayer shall use such ratios in computing a claim for a tentative allowance for amortization. Such tentative allowance may be redetermined on or before March 3, 1924, at the request of the taxpayer or by the Commissioner.

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<sup>2</sup> "The value in use is to be tested by a maximum and a minimum value—the maximum being the post-war conditions and

the minimum being the sale or salvage value. Even though the property can be used to its fullest capacity for post-war operations,

Special record of all property falling in (1) above, must be preserved by the taxpayer, and the Commissioner must be notified with the next tax return (a) if, after having been in good faith permanently discarded or dismantled, property shall in any case be restored to use because of conditions not foreseen or anticipated at the time it was discarded; or (b) of the selling price, if sold.

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still the taxpayer is entitled to any excess cost that there may have been in these facilities between the actual cost to him during the war period of high costs and the stable post-war values as determined.

"The determination of the worth of property to a going concern is an engineering, accounting, and appraisal problem which involves the consideration of such factors as the cost of reproduction, all facts in connection with

the operations, the past history of the concern, the post-war operations and efforts to use the property, the present use to which it is being put, its modernness, adaptability for present use, and the degree of utilization, involving the question of whether the property is used to its fullest extent or, if not, whether such use is contemplated in the future." (Bulletin 537, March 2, 1922, of The American Appraisal Company.)



## CHAPTER VII

### Invested Capital

**Purpose of Appraisal:** To properly establish, rectify, and build up records of invested capital, where for any reason the books of account may not constitute a proper statement thereof.

#### Law

SECTION 326(a), REVENUE ACT OF 1921.

That as used in this title the term "invested capital" for any year means (except as provided in subdivisions (b) and (c) of this section) :

1. Actual cash bona fide paid in for stock or shares.
2. Actual cash value of tangible property, other than cash, bona fide paid in for stock or shares, at the time of such payment. . . . .
3. Paid-in or earned surplus and undivided profits; not including surplus and undivided profits earned during the year.
4. Intangible property bona fide paid in for stock or shares prior to March 3, 1917. . . . .
5. Intangible property bona fide paid in for stock or shares on or after March 3, 1917. . . . .

*(For specific exceptions and details see Section 326, Revenue Act of 1921.)*

## Regulations

### ARTICLE 831, REGULATIONS 62. *Meaning of Invested Capital:*

Invested capital within the meaning of the statute is the capital actually paid in to the corporation by the stockholders, including the surplus and undivided profits, and is not based upon the present net worth of the assets, as shown by an appraisal or in any other manner. The basis or starting point in the computation of invested capital is found in the amount of cash and other property paid in, the valuation at which such other property may be included being determined in accordance with the statute and the regulations. The computation does not stop, however, with such original entries or amounts, but also takes into account the surplus and undivided profits of prior years left in the business. The invested capital of a corporation includes, generally speaking:

- (a) The cash paid in for stock,
- (b) The tangible property paid in for stock,
- (c) The surplus and undivided profits, and
- (d) The intangible property paid in for stock (to a limited amount), less, however, the same proportion of such aggregate sum as the amount of inadmissible assets bears to the amount of the admissible assets and the inadmissible assets held during the taxable year. Invested capital does not include borrowed capital. See section 325 of the statute and articles 811-818 of Regulations. The fair market value of the assets as of March 1, 1913, has no bearing on invested capital. See section 202 and article 1561.

### ARTICLE 836, REGULATIONS 62. *Tangible Property Paid In: Value in Excess of Par Value of Stock: See page 59 for Amended Article.*



ARTICLE 839, REGULATIONS 62. *Surplus and Undivided Profits: Allowance for Depletion and Depreciation:*

Adjustments in respect of depreciation or depletion in prior years will be made or permitted only upon the basis of explicit and convincing evidence (and calculations based upon a theoretical formula are not such evidence) that as at the beginning of the taxable year the amount of depreciation or depletion written off in prior years was insufficient or excessive, as the case may be, and in every such case due regard must be given to expenditures made by the taxpayer to maintain the effective usefulness of the property.

**Rulings**

A. R. M. 106

Bulletin 18-21-1614

It is the judgment of the Committee that there is no warrant for reducing earned surplus because of alleged failure to charge off sufficient depreciation in the past, unless the depreciable assets of the corporation are valued on its books at the beginning of the taxable year at an amount in excess of their actual value at that time.<sup>1</sup> This is particularly true where the corporation in prior years earned positive income from which larger deductions for depreciation might have been taken, if in the

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<sup>1</sup> "Specific inquiry has been made as to the meaning of the words 'actual value' as used in Committee on Appeals and Review Memorandum 106. For the purposes of taxation, depreciation is based upon cost. Accordingly, the words 'actual value' mean 'sound value,' which is 'original cost' (or value as of March 1, 1913, if applicable), including additions and betterments charged

to capital account, less depreciation sustained." (Internal Revenue Bulletin 30-21-1748.)

"This use of the words 'actual value' and 'sound value' is misleading from the appraisal point of view and must be interpreted as meaning 'depreciated cost' as used by us." (Bulletin No. 516 of The American Appraisal Company.)

opinion of the officers and directors of the corporation such larger charges had been justified. Nothing herein is to be construed as precluding the Income Tax Unit from adjusting depreciation, either by way of increase or decrease, where there is at hand affirmative evidence that as at the beginning of a taxable year the amount of depreciation written off in prior years was insufficient or excessive.

A. R. M. 106 Explained 30-21-1748

Mere failure in prior years to have written off on the books the maximum or ordinary rate of depreciation is not in itself "affirmative evidence." There is no warrant for reducing earned surplus because of alleged failure to charge off sufficient depreciation in the past, unless the depreciable assets of the corporation are valued on its books at the beginning of the taxable year at an amount in excess of their sound value at that time.<sup>2</sup>

## Regulations

ARTICLE 840, REGULATIONS 62. *Surplus and Undivided Profits: Additions to Surplus Account:*

A corporation's books of account will be presumed to show the facts.<sup>3</sup> If it claims that its capital or surplus

<sup>2</sup> "This interpretation of A. R. M. 106 recognizes the principle upon which we base our reports on property costs: that the 'actual value' — that is the original cost, or the value at March 1, 1913 — and not the mere book figure of the property, is the sum which is to be included in invested capital.

"Not only does it recognize the principle, but an appraisal is also recognized; for when a taxpayer asserts that his depreciation is less than that determined by the

inspector, he may verify his claim 'by determining the value of the capital assets remaining,' and the Committee on Appeals and Review states that this is the more accurate method." (*The American Appraisal News*, July, 1921, page 176.)

<sup>3</sup> "There are many reasons why it is necessary or desirable to re-adjust the plant accounts for the purpose of determining the correct invested capital. Plant accounts carried forward through a

account is understated the burden of proof will rest upon it. Additions to such accounts will be accepted to the following extent:<sup>4</sup>

1. Excessive depreciation heretofore charged off on property still owned and in use, if it is now shown by explicit and convincing proof to have been excessive and such excess is substantial in amount, whether or not disallowed by the Commissioner as a deduction from net income, may be restored to the surplus account<sup>5</sup>. No such amount shall be restored, however, unless it is shown that adequate depreciation has been deducted upon all other property of the corporation still in use, nor in any case in which such amount has been allowed as a deduction for amortization under section 234(a) (8) of the statute, or in which the cost of the property has been recovered through being included in the price of goods or services, as for example, in the case of patterns, dies, plates, special tools, etc., or under a munition contract with a foreign Government.

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period of time fail to record the true investment in the property, as the accounts may have been written down through excessive depreciation not credited to specific reserves; betterments may have been charged to expense, and vice versa; properties may have been enlarged, revamped, and changed in such manner as to lose correct record of the remaining investment; earnings may have been put into the properties without proper analysis and charges; and the original records may be lost or inadequate." (*The American Appraisal News*, February, 1919, page 14.)

<sup>4</sup> "In reconstructing the property accounts, the appraiser works from the direct evidence, the property itself, and uses the prop-

erty records for supplementary information. The actual existence of the property, its normal cost at date of acquisition, and its present condition, must be the basis for final judgment." (*The American Appraisal News*, March, 1919, page 4.)

<sup>5</sup> "The remaining expectancy of life of the property and its condition, as determined through examination by a competent appraisal organization, presents the strongest possible evidence as to whether or not excessive depreciation has been charged off, and the amounts of the excesses which should properly be restored to surplus." (H. B. Hall of The American Appraisal Company in *The Clay Worker*, for February 28th, 1922, page 255.)

2. Amounts which have been expended before January 1, 1917, for the acquisition of plant, equipment, tools, patterns, furniture, fixtures, or like tangible property, having a useful life extending substantially beyond the year in which the expenditure was made, and which have been charged as current expense, may (less proper deductions for depreciation or obsolescence) be added to the surplus account when such assets are still owned and in active use by the corporation during the taxable year. Special tools, patterns, and similar assets shall not be assigned any value if their cost has been recovered through having been included in the price of goods. If their cost has not been so recovered and they are held for only occasional use, they shall not be assigned a value in excess of the fair value based upon the earnings actually arising from their current use, and in no case shall such value be more than the cost less depreciation. Assets of this kind not in current use shall not be valued at more than their nominal or scrap value.<sup>6</sup>
3. Amounts which have been expended in the past for intangible property of any kind can be restored to capital or surplus account only to the extent that the corporation specifically paid such amounts for the intangible property as such. For provisions relating to patents see Article 843. [Page 49.]
4. Adjustments necessary to correct other errors found in the books of account may be made.<sup>7</sup>  
[But see Article 841, page 48.]

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<sup>6</sup> "Where, however, it can be shown with reasonable assurance than an appraisal value does not contain a material amount of appreciation, but that on the contrary it is on a basis substantially of cost less depreciation actually accrued, the author sees no objection (nor is there any inhibition against it in the excess profit tax laws) to using such an ap-

praisal as the basis for restoring in effect capital expenditures which were absorbed in operating expenses in earlier years." (Montgomery's *Income Tax Procedure*, 1922, page 1589.)

<sup>7</sup> "The best check on the accuracy of the book records of invested capital is an appraisal. By means of an appraisal and a record of the date on which the prop-

ARTICLE 844, REGULATIONS 62. *Surplus and Undivided Profits: Reserve for Depreciation or Depletion:*

If any reserves for depreciation or for depletion are included in the surplus account it should be analyzed so as to separate such reserves and leave only real surplus. Reserves for depreciation or depletion can not be included in the computation of invested capital, except to the following extent:

1. Excessive depletion or depreciation included therein and which if charged off could be restored under article 840 may be included in the computation of invested capital; and
2. Where depreciation or depletion is computed on the value as of March 1, 1913, or as of any subsequent date, the proportion of depreciation or depletion representing the realization of appreciation of value at March 1, 1913, or such subsequent date, may if undistributed and used or employed in the business be treated as surplus and included in the computation of invested capital.

For the purpose of computing invested capital, depreciation or depletion computed on the value as of March 1, 1913, or as of any subsequent date shall, if such value exceeded cost, be deemed a pro rata realization of cost and appreciation and be apportioned accordingly. Except as above provided, value appreciation which has not been actually realized and in respect of

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erty was acquired, the normal costs as of the date of acquisition and the correct allowances for depreciation to date can be determined.

"This will permit a readjust-

ment of the capital account as provided by the provisions of the excess profits tax law and regulations." (The American Appraisal Company, Bulletin 458, January 1, 1918.)

amounts accrued since March 1, 1913, reported as income for the purpose of the income tax, can not be included in the computation of invested capital, and if already reflected in the surplus account it must be deducted therefrom.<sup>8</sup>

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<sup>8</sup> "The invested capital, however, is primarily based upon the property in use at the beginning of, and during the taxable year, and an appraisal made for the purpose of readjusting the plant accounts for determining the invested capital, must include the inspection and listing of such property, but the prices must be

on the basis of actual costs of property purchased or the value at date of acquisition of property paid in, with deductions for depreciation and depletion accrued at the beginning of and during the taxable year." (*Appraised Values*, booklet published by The American Appraisal Company, 1919.)



## CHAPTER VIII

### Reorganizations

**Purpose of Appraisal:** To determine the investment in fixed assets for concerns which have undergone reorganization, in accordance with the conditions specified by law.

#### Law

##### SECTION 331, REVENUE ACT OF 1921:

That in the case of the reorganization, consolidation, or change of ownership of a trade or business, or change of ownership of property, after March 3, 1917, if an interest or control in such trade or business or property of 50 per centum or more remains in the same persons, or any of them, then no asset transferred or received from the previous owner shall, for the purpose of determining invested capital, be allowed a greater value than would have been allowed under this title in computing the invested capital of such previous owner if such asset had not been so transferred or received:<sup>1</sup> *Provided*, That if such previous owner was not a corporation, then the value of any asset so transferred or received shall be taken at its cost of acquisition (at the date when acquired by such previous owner) with proper allowance for depreciation, impairment, better-

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<sup>1</sup> The use of a retrospective appraisal in determining invested capital in this case is controlled by the provisions of Section 326,

Revenue Act of 1921, and the attendant Regulations and Rulings cited under the subject, "Invested Capital," see pages 35-42.



ment or development, but no addition to the original cost shall be made for any charge or expenditure deducted as expense or otherwise on or after March 1, 1913, in computing the net income of such previous owner for purposes of taxation.<sup>2</sup>

## Rulings

A. R. M. 60

Bulletin 25-20-1022

### Revenue Act of 1917

The necessary corollary of the provision quoted above is that if the reorganization, consolidation, or change of ownership took place prior to March 3, 1917, the actual value of the assets paid in, limited by the provisions of section 207, is the invested capital.<sup>3</sup>

<sup>2</sup> "Two inferences are to be fairly drawn from this provision:

1. Assets in the case of reorganization prior to March 3, 1917, should be valued as of the date of transfer to the new corporation for the purpose of determining the invested capital of such corporation for the taxable year;
2. Assets in the case of a reorganization after March 3, 1917, should be valued as of the date of the transfer to the new corporation for the purpose of determining the invested capital of such corporation for the taxable year, if an interest or control in the trade, business or property transferred upon the reorganization does not remain to the extent of 50% or more in the same persons." (*Holmes Federal Taxes*, page 1085.)

<sup>3</sup> "The following recommendation of the Committee emphasizes the point that property taken over in reorganizations prior to March 3, 1917, must be valued as at the date of transfer, and also provides that an appraisal may be used to establish such value:

*Ruling:* Held, that the appraised value of the plant of a corporation based on cost as of December 22, 1919, plus depreciation from February 14, 1917, the date the property was taken over to that date, be used to determine the value at February 14, 1917; that depreciation rates be determined by the life of the property and applied to value determined at acquisition, with an accelerated rate on machinery during 1917 when the plant was running at double capacity \* \* \* (C.B. 4, page 371; A.R.R. 390.)" (*Montgomery's Income Tax Procedure*, 1922, page 1648.)

## CHAPTER IX

### Intangible Properties

**Purpose of Appraisal:** To establish the investment in and value of intangibles as a basis for the computation of depreciation, gain or loss on sale, and invested capital.<sup>1</sup>

#### Law

SECTION 326(a), REVENUE ACT OF 1921—*See page 35:*

*Also paragraphs 4 and 5 of Section 326(a), quoted below;* Invested Capital includes:

(4) Intangible property bona fide paid in for stock or shares prior to March 3, 1917, in an amount not exceeding (a) the actual cash value of such property at the time paid in, (b) the par value of the stock or shares issued therefor, or (c) in the aggregate 25 per centum of the par value of the total stock or shares of the corporation outstanding on March 3, 1917, whichever is lowest;

(5) Intangible property bona fide paid in for stock or shares on or after March 3, 1917, in an amount not exceeding (a) the actual cash value of such property at the time paid in, (b) the par value of the stock or shares issued therefor, or (c) in the aggregate 25 per centum

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<sup>1</sup> This section is for the purpose of more specific reference to the conditions governing the de-

termination of intangible investment and values.

of the par value of the total stock or shares of the corporation outstanding at the beginning of the taxable year, whichever is lowest: *Provided*, That in no case shall the total amount included under paragraphs (4) and (5) exceed in the aggregate 25 per centum of the par value of the total stock or shares of the corporation outstanding at the beginning of the taxable year.

NOTE: *The limitation imposed by (5 c) above was 20% under the Act of 1917.*<sup>2</sup>

*See also Section 202, Revenue Act of 1921, page 17; and Section 214(a) (8), page 21.*

## Regulations

### ARTICLE 40, REGULATIONS 62. *Sale of Patents and Copyrights:*

A taxpayer disposing of patents or copyrights by sale should determine the profit or loss arising therefrom by computing the difference between the selling price and the cost. The taxable income in the case of patents or copyrights acquired prior to March 1, 1913, should be ascertained in accordance with the provisions of Article 1561. The profit or loss thus ascertained should be increased or decreased, as the case may be, by the amounts deducted on account of depreciation of such patents or copyrights since February 28, 1913, or since the date of acquisition if subsequent thereto. See article 167 [page 48].

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<sup>2</sup> T.B.M. 19    Bulletin 3-19-208.  
For the purpose of computing the  
excess profits tax for 1917, the  
capital stock paid for patents is

not subject to the 20% limitations  
applicable to good will and cer-  
tain other forms of intangibles.

ARTICLE 41, REGULATIONS 62. *Sale of Good Will:*

Any profit or loss resulting from a sale of good will can be taken only when the business, or a part of it, to which the good will attaches is sold, in which case the profit or loss will be determined upon the basis of the cost of the assets, including good will. If the good will was acquired prior to March 1, 1913, the taxable gain or deductible loss should be ascertained in accordance with the provisions of Article 1561. If specific payment was not made for good will acquired after February 28, 1913, there can be no deductible loss with respect thereto, but profit may be realized from the sale of good will built up through expenditures which have been currently deducted. It is immaterial that good will may never have been carried on the books as an asset, but the burden of proof is on the taxpayer to establish the cost or fair market value on March 1, 1913, of the good will sold. See Article 163.

ARTICLE 143, REGULATIONS 62. *See page 28.*

ARTICLE 163, REGULATIONS 62. *Depreciation of Intangible Property:*

Intangibles, the use of which in the trade or business is definitely limited in duration, may be the subject of a depreciation allowance. Examples are patents and copyrights, licenses, and franchises. Intangibles, the use of which in the business or trade is not so limited, will not usually be a proper subject of such an allowance.<sup>3</sup>

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<sup>3</sup> "The Income Tax Acts are clear in their intent to have the value carried on the books represent the actual cost of the patent to the owner in all cases, except where the patent was owned by him prior to March 1, 1913, when the fair market value on March

1, 1913, may be substituted in that year and such appraised value used as a basis of depreciation during the remaining years of the life of the patent." (Frye *On The Income Tax as Affected by Patents and Trade-Marks*, page 72.)

ARTICLE 167, REGULATIONS 62. *Depreciation of Patent or Copyright:*

In computing a depreciation allowance in the case of a patent or copyright, the capital sum to be replaced is the cost (not already deducted as current expense) of the patent or copyright or its fair market value as of March 1, 1913, if acquired prior thereto. \* \* \* If the patent becomes obsolete prior to its expiration such proportion of the amount on which its depreciation may be based as the number of years of its remaining life bears to the whole number of years intervening between the date when it was acquired and the date when it legally expires may be deducted, if permission so to do is specifically secured from the Commissioner.<sup>4</sup>

ARTICLE 841, REGULATIONS 62. *Surplus and Undivided Profits: Limitation of Additions to Surplus Account:*

Additions to surplus which a corporation may desire to make under the preceding article fall broadly into two classes:

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<sup>4</sup> "The benefit to a company of substituting on its books the 'fair market value' as of March 1, 1913, of its patents, trade-marks, etc., in force at that time is believed to be apparent. Such market value is in practically all cases greatly in excess of the cost value of the patents, etc.—the value ordinarily entered on a company's books—and the company thus enters an asset that can be depreciated proportionately during the remaining years of the life of the patents. In one instance, the value of patents, etc.,

was raised in this way from a figure of less than \$500,000 to \$7,000,000, and the annual depreciation reduction thus afforded for the next few years very materially reduced the net income figures in their tax returns, and in consequence, the taxes paid were greatly reduced. Particularly, where a company has carried its patents, etc., at a nominal figure, the saving in taxes due to revaluing them in this manner would be considerable." (*Ibid.*, page 82.)



(2) To reinstate in surplus deductions from income which are as a matter of good accounting to some extent optional, such as experimental expenses, patent litigation, development of good will through advertising or otherwise, etc.

Adjustments falling in class (2) can not usually be permitted, as in such cases where the treatment of the item was optional and the decision made at the time conformed to the best accounting practice, it is considered that the corporation has exercised a binding option in deducting such expenses from income. An election of this sort which was made concurrently with the transaction can not now be revised, and amended returns in respect thereof can not be accepted.

ARTICLE 843, REGULATIONS 62. *Surplus and Undivided Profits: Patents:*

From the standpoint of assets a patent, or more particularly a group of patents, is closely analogous to good will. Their value is contingent upon and measured by their earning power. While patents have a definite life, there is a common tendency to extend that life by improvements upon the original, and in a successful business the patent value merges more or less completely into a trade name or other form of good will. Therefore, while deductions in respect to the depreciation of patents based upon a normal life period of seventeen years are allowable in computing net income for the purpose of the income tax, such deductions are not obligatory, but are optional with each taxpayer. Where since January 1, 1909, a corporation has exercised that option to its own benefit in computing its taxable net income the amount so deducted can not now be restored in computing invested capital. Where,

however, the cost of patents has been charged against surplus or otherwise disposed of in such a manner as not to benefit the corporation in computing its taxable net income since January 1, 1909, any amount so written off may be restored in computing invested capital, if it be shown to the satisfaction of the Commissioner that the amount so written off represented a mere book entry ascribable to a conservative policy of management or accounting and did not represent a realized shrinkage in the value of such assets. Any amount so restored may not be written off by way of deductions from taxable net income in any subsequent year or years. Where a corporation has charged to current expenses the cost of developing or protecting patents, no amount in respect thereof expended since January 1, 1909, can be restored in computing invested capital. In respect of expenditures made before January 1, 1909, a corporation now seeking to restore them must be prepared to show to the satisfaction of the Commissioner that all such items are proper capital expenditures. It can not be said that the correct computation of surplus and undivided profits necessarily requires a deduction in respect of the expiration of patents. It follows, therefore, that where a corporation in the exercise of its option has not written down the cost of patents, it is not ordinarily necessary to reduce the surplus and undivided profits in computing invested capital, whether the patents have been acquired for stock or shares or for cash or other tangible property. Due consideration will be given to the facts in any case in which this rule seems obviously unreasonable.<sup>5</sup> See Article 167 [page 48].

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<sup>5</sup> "In general, the Commissioner is required to adopt the standards

and definitions of value which have been approved by the United



ARTICLE 1561, REGULATIONS 62. *See page 18.*

### Rulings

T. B. R. 44—15-19-445—*See page 30.*

O. D. 298 Bulletin 24-19-565

Deductions from gross income on account of depreciation or obsolescence of intangibles, such as good will, trade-marks, and trade-brands, allowed distillers and dealers in liquors, are also applicable to brewers.<sup>6</sup>

O. D. 472 Bulletin 17-20-884

Obsolescence is not ordinarily applicable in the case of intangibles but will be allowed in exceptional cases, as in the case of the discontinuance of a going business because of the exhaustion of its source of supply, where the cost of the good will, or its value as of March 1, 1913, if acquired prior to that date, can be definitely shown and the period of its obsolescence determined with reasonable accuracy.

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States Supreme Court. The Treasury, while not perhaps applying strict technical rules of evidence in matters of this kind, necessarily receives and gives the same weight to evidence admissible in court as would be accorded to such evidence by a court. It therefore becomes important to consider what attitude the courts may take with respect to the establishment of value of property having no technical market value. The courts not only permit, but require, that persons should be brought before the court who, from their technical experience and knowledge, are better quali-

fied to form a judgment concerning the real value of such property than is the ordinary citizen; they require such person to detail his experience and means of knowledge to the jury, and then they permit him to express his opinion as to the actual value of the property in question, based upon his knowledge of that property in particular and upon his experience in general." (*Montgomery's Income Tax Procedure*, 1922, page 656.)

<sup>6</sup> See foot note 2 on page 30, and also O.D. 1001 on the same page.

A. R. M. 34

10-20-777

In any or all of the cases the effort should be to determine what net earnings a purchaser of a business on March 1, 1913, might reasonably have expected to receive from it, and therefore a representative period should be used for averaging actual earnings, eliminating any year in which there were extraordinary factors affecting earnings either way. Also, in the case of the sale of good will of a going business the percentage rate of capitalization of earnings applicable to good will shown by the amount actually paid for the business should be used as a check against the determination of good will value as of March 1, 1913, and if the good will is sold upon the basis of capitalization of earnings less than the figures above indicated as the ones ordinarily to be adopted, the same percentage should be used in figuring value as of March 1, 1913.

## CHAPTER X

### Retrospective Appraisals

As Defined and Prescribed by The Treasury Department

A. R. R. 747

Bulletin 1-5-60

#### Revenue Acts of 1917 and 1918

Recommended, upon the reconsideration of the appeal in the case of the M Corporation from the action of the Income Tax Unit in holding that the invested capital can not be satisfactorily established and that assessment of excess profits taxes for the year 1917 should be made under the provisions of section 210 of the Revenue Act of 1917 and for subsequent years under the provisions of sections 327 and 328 of the Revenue Act of 1918, be reversed; that Committee on Appeals and Review Recommendation 490 sustaining the action of the Unit be revoked; that retrospective appraisals be accepted as evidence of paid-in surplus when made upon the basis herein outlined and the facts upon which the appraisals are based have been established by proof; that the retrospective appraisals and the facts upon which they are based in the instant case be verified to determine the method of their construction and the truth of

the facts upon which they are based; and that in this and in all similar cases where the law directs that the value of property at a given basic date be ascertained, the Unit be instructed to receive such proof of the facts as is ordinarily accepted in important business transactions of like character and that the practice which has obtained in the Unit in refusing to receive such proof on the ground that it consisted of so-called retroactive appraisals be discontinued.

In the past it has been the policy of the Bureau to construe strictly the requirements of Article 63, Regulations 41, and Article 836, Regulations 45 (1920 edition). As a result of such construction of these articles numerous retroactive or retrospective appraisals have been rejected as a basis for a claim for paid-in surplus.<sup>1</sup> The Committee has made an exhaustive study of appraisals and their relation to invested capital of corporations. It has also considered appraisals in connection with establishing March 1 values for purposes of depreciation and depletion, and for purposes of establishing certain values in connection with amortization claims, and has reached the conclusion that the Unit has been too strict in interpreting the provisions of the statute and the articles of regulations interpreting same quoted above, and that retrospective appraisals, if made

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<sup>1</sup> "In the Department [Treasury Department] there have been appraisals thrown out and properly so . . . . They should have been thrown out. As appraisers we like to see the standard maintained, and to my mind, the Department cannot be too

strict in acceptance or rejection of appraisals." (Address of Lyle H. Olson, Vice-President of The American Appraisal Company before a regional meeting of The American Institute of Accountants, Detroit, Mich., April 8, 1921.)

upon the basis hereinafter outlined and proof is furnished of the facts upon which they are based, may properly be accepted as a basis for the allowance of a paid-in surplus. The Unit, as well as the Committee, is continually fixing values for one purpose or another. This is particularly true in fixing the March 1 values for the purpose of computing gain or loss upon the sale of an asset which has been held for some time and which is of a class not regularly dealt in by the public.

In making a retroactive or retrospective appraisal to show the actual cash value of tangible assets at the time paid in at some date in the past, care should be exercised in order to eliminate any appreciation written upon the books of the corporation since the date of acquisition, and also to value the assets in question at cost. In the case of the *La Belle Iron Works vs. United States* (C. B. 4, p. 373), decided by the Supreme Court on May 16, 1921, it was held that any appreciation in value of property over its cost is not to be included in invested capital as paid-in surplus. Treasury Decision 3220 (Bulletin 37-21-1822) was promulgated subsequent to this decision and requires the filing of amended returns in all cases where taxpayers have written appreciated or inflated values upon their books and have used same in determining the amount of their invested capital. It would, therefore, appear that no appreciation over cost can be recognized in the computation of invested capital and that appraisals made for the purpose of establishing invested capital and for the purpose of allowance of a paid-in surplus should be based upon the actual cost of the tangible properties as they existed at the time they were paid in, giving particular attention and consideration to the original cost and depreciated

reproduction cost as at the basic date and the remaining expectancy of life. In order to accomplish this result it will be necessary to inventory at cost as of the basic date (the date of acquisition) the property then on hand and in many cases to establish by historical investigation the date of original acquisition, date of renewal, and the cost of additions made subsequent to the date the property was paid in. Adjustments should be made for property scrapped or discarded and for depreciation.<sup>2</sup>

The books of account, if available, should be considered the best evidence as to dates of acquisition and actual cost. The asset account showing the tangible property may be incomplete for many reasons and may include property still on the books that has been discarded as well as property in existence that has never been capitalized or entered on the books and certain arbitrary amounts charged off as depreciation which have no relation to the expired and remaining life of the property.<sup>3</sup>

The tangible property actually in existence and in use should be considered as the basic evidence of the invested capital in existence and should be used as a basis

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<sup>2</sup> "The basis for this is an inventory of the property supplemented by an historical investigation to determine the dates of original acquisition, renewals, and the actual costs or where permitted, the value as of the date the property was paid in." (Bulletin 507, Nov. 17, 1921, of The American Appraisal Company.)

<sup>3</sup> "A corporation's books of account will be presumed to show the facts. It is plant or property accounts that are the chief con-

cern of the appraiser, and these accounts may be incomplete and incorrect for many reasons not here necessary to discuss in detail but including property still on the books that has been discarded during prior years, omitted costs for property in existence that have never been capitalized, and including arbitrary depreciation allowances that have no relation to the expired and remaining serviceable life of the property." (Ibid.)



for the proper correction of the accounts to correctly reflect the actual investment in the depreciable properties in existence during the taxable years.<sup>4</sup>

The burden of proof is upon the taxpayer when a claim for a paid-in surplus is made, and in so far as the records of the taxpayer may be incomplete or the regulations permit values of the property at the date paid in should be established by proof. The regulations quoted above do not prescribe any specific method for ascertaining the facts, but only indicate some of the means by which appropriate proof may be furnished which would be acceptable to the Bureau. A retrospective appraisal is in substance the opinion of experts based upon the facts presented to them and as such is admissible as evidence of a paid-in surplus, but its value as proof of a paid-in surplus must depend upon the truth of the facts upon which it is based. Necessarily, if any of the facts presented to the experts are not accurate, the experts' opinion is inaccurate to the extent that such facts are inaccurate. In order, therefore, for the Bureau to accept as conclusive a retrospective appraisal, it must be satisfied under the regulations that the facts upon which the appraisal is based are true. In determining whether or not the facts are true the Bureau should accept such proof of the facts as is ordinarily accepted in business transactions of like character. In all such inquiries the Bureau is dealing with facts which themselves come within the control of human will or human caprice, and the evidence for which depends on the trustworthiness

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<sup>4</sup> "The aim of the appraiser is to work from the property as the basic evidence from which to furnish the information for the proper correction of the accounts to re-

fect correctly the actual investment in and the depreciation of the properties in existence during the taxable years." (Ibid.)



of human informants. Such evidence may range through every degree, from the barest likelihood to that undoubted moral certainty on which every man acts without hesitation in practical affairs. The Bureau must receive and consider such appraisals, therefore, with a sound and intelligent discretion as it considers much other evidence, and be content to accept them, without being able to prove their accuracy as mathematicians judge accuracy, if they convince the mind of their correctness to that moral certainty upon which practical men of affairs act.

In view of the foregoing, it is recommended that the action of the Income Tax Unit in holding that the invested capital can not be satisfactorily established and that assessments of excess profits taxes for the year 1917 should be made under the provisions of Section 210 of the Revenue Act of 1917 and for subsequent years under the provisions of Sections 327 and 328 of the Revenue Act of 1918 be reversed; that Committee on Appeals and Review Recommendation 490 sustaining the action of the Unit be revoked; that retrospective appraisals be accepted as evidence of paid-in surplus when made upon the basis herein outlined and the facts upon which the appraisals are based have been established by proof; that the retrospective appraisals and the facts upon which they are based in the instant case be verified to determine the method of their construction and the truth of the facts upon which they are based; and that in this and in all similar cases where the law directs that the value of property at a given basic date be ascertained, the Unit be instructed to receive such proof of the facts as is ordinarily accepted in important business transactions of like character and that the practice which has obtained

in the Unit in refusing to receive such proof on the ground that it consisted of so-called retroactive appraisals be discontinued.

T. D. 3367

Bulletin 1-30-431

Article 836, Regulations 45 (1920 edition), and Article 836, Regulations 62, are hereby amended to read as follows:<sup>5</sup>

ARTICLE 836. *Tangible property paid in; value in excess of par value of stock.* The paid-in surplus allowed in any case is confined to the value definitely known or accurately ascertainable at the time the property is paid in. Evidence offered to support a claim for a paid-in surplus must be as of the date of the payment. It may consist among other things of (a) an appraisal of the property by disinterested authorities, (b) a certificate of the assessed value in the case of real estate, or (c) evidence of a market price in excess of the par value of the stock or shares. Opinion evidence, expert or otherwise, of the value of property as of a prior date will not be accepted.<sup>6</sup> Retrospective appraisals submitted in sup-

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<sup>5</sup> Though this amended regulation refers particularly to the establishment of a paid-in surplus by reason of the value of the property paid in being in excess of the par value of stock issued for it, its specific requirements in regard to retrospective appraisal service and the general principles which it emphasizes establish it as possibly the most important statement of the Bureau of Internal Revenue insofar as retrospective appraisals are concerned. It will likely be followed by others of an equally definite nature, defining the elements of acceptable

retrospective appraisals for other income tax usages. A Review of Chapter I and of the footnotes throughout this book will immediately indicate that The American Appraisal Company has anticipated the governmental requirements by a number of years and that as a consequence its service has been developed, and its reports executed in specific accord with the stipulations now promulgated by this ruling.

<sup>6</sup> Here the Government again distinguishes between opinion values and appraised values, a distinction recognized years ago by

port of a claim for a paid-in surplus will not be accepted in any case where other reasonably satisfactory evidence<sup>7</sup> is available and in any case will be accepted only after rigid scrutiny<sup>8</sup> and will be followed only to the extent to which their reasonableness is fully established.<sup>9</sup> The property which was paid in is the basis of the appraisal, and the appraisal must reconcile the accounts so as to reflect accurately the actual value on the date as of which the appraisal is made and the depreciation sustained. Proper consideration must in all cases be given to depreciation and the expired and remaining serviceable life of the property must be shown. To be acceptable retrospective appraisals must show:

1. The history of the business and manner in which the information or data was acquired;
2. The manner in which the appraisals were constructed;
3. The inventory on the date of the appraisal in detail;<sup>10</sup>

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The American Appraisal Company and accepted as the foundation upon which its service has been built. For a more detailed definition of this distinction see page 10.

<sup>7</sup> Obviously, no one would go to the expense of a retrospective appraisal if there were any "other reasonably satisfactory evidence," but unfortunately the errors and fallacies which make a retrospective appraisal necessary have been inherent in plant accounting during past years, and as a consequence, there is frequently no other recourse for the taxpayer than to have a retrospective appraisal made to supply the deficiencies of his accounts. In the specific case referred to here, that is the determination of a paid-in surplus, the possibili-

ties for securing other reasonably satisfactory evidence are meager.

<sup>8</sup> This is patently a specific statement of a policy long in vogue in the Internal Revenue Department; that is: to accept nothing at its face value. Retrospective appraisal reports must be complete and must be invulnerable against any attack.

<sup>9</sup> In actual practice, the Department frequently goes further than this, and throws out a report in its entirety when any phase of it is unreasonable.

<sup>10</sup> Retrospective appraisals ordinarily supplement current value appraisals in which is included all property in existence *at the time the examination of the property is made*. This provision now makes it obligatory that all of the properties be at least inven-

4. The date of acquisition of all items remaining in the inventory as of the date of appraisal;<sup>11</sup>
5. The elimination from the inventory of all items acquired subsequent to the date as of which the appraisal is made and how this was effected (all items, the date of acquisition of which can not be definitely determined, should be listed separately, and all the facts bearing upon the date of acquisition given);
6. The replacement cost at the date as of which the appraisal is made of each item accepted as on hand on that date determined upon competent data,<sup>12</sup> with a statement of the method employed in arriving at such cost (estimates and general statements will not be accepted);<sup>13</sup>
7. The rate and total amount of depreciation as shown by the books;
8. The rate and total amount of depreciation taken upon each item included in the appraisal for the purposes of the appraisal (if other than normal rates of depreciation are used the reason therefor and the method of computing depreciation must be fully explained);<sup>14</sup>
9. The actual cost when ascertainable of each item included in the appraisal;<sup>15</sup>

toried as of the date of the examination. The purpose of this is to enable the Government to check the eliminations of items acquired between the dates *as of which* the retrospective appraisal is made and the date of the examination.

<sup>11</sup> The date of acquisition to the corporation claiming a paid-in surplus, would, of course, be the date on which the property was paid in. All of the property included in the appraisal as of the date paid in would have the same date of acquisition. The purpose of this requirement, however, is apparently to check the expired life of each item of property at the date paid in; and it is

therefore necessary to show the date of acquisition of each item by the original purchasers.

<sup>12-13</sup> Note again the necessity for authoritative pricing data for past years, and the discrimination against opinion evidence.

<sup>14</sup> The tenor of this complete amendment is wholly for facts rather than for opinion. Here, for instance, the Government emphasizes the necessity of having authoritative statistics on the expectancy of life and the affect of maintenance as a support for depreciation statements.

<sup>15</sup> By "actual cost" is meant the actual cost to the original purchaser. The cost to the corporation claiming the paid-in surplus

10. The book value on the date as of which the appraisal is made of all the items included in the appraisal; and
11. A detailed statement of all plant facilities and additions, represented by capital expenditures previously written off, which were still in use on the date as of which the appraisal was made and all the depreciation actually sustained or accrued on such items. No claim will be allowed for paid-in surplus in any case in which the addition of value has been developed or ascertained<sup>16</sup> subsequent to the date on which the property was paid in to the corporation, or in respect of property which the stockholders or their agents on or shortly before the date of such payment acquired at a bargain price, as for instance, at a receiver's sale. Generally, allowable claims under this article will arise out of transactions in which there has been no substantial change of beneficial interest in the property paid in to the corporation and in all cases the proof of value must be clear and explicit.<sup>17</sup>

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would be the value of the stock issued for the property paid in, allocated to each item.

<sup>16</sup> This is designed to prevent the inclusion in values established through retrospective appraisal service, of appreciation incurred subsequent to the date as of which the appraisal is made and attributable to any cause whatsoever.

<sup>17</sup> Briefly summarized, the character of the retrospective appraisal service necessary to meet the requirements imposed by this amendment would be as follows:

1. A detailed inventory of all property in existence at the time of the examination.
2. Itemized dates of acquisition by the original purchaser.

3. Actual costs by items to the original purchaser when obtainable; and
4. Authoritatively established normal costs at dates of acquisition by original purchaser wherever actual costs are not obtainable.
5. The cost of reproduction, accrued depreciation, and sound value of that part of the property definitely established as being on hand at the date paid in, as of such date.
6. A report reconciling the appraisal and the books.
7. A report meeting the other requirements of a general explanatory nature as set forth in this Decision.



## CHAPTER XI

# Appreciation Not Income

### Ruling

C. T.—MIM—1070.

Likewise and conversely any appreciation in the value of assets due to appraisal or adjustment and taken up on the books of the individual or corporation is held not to be income within the meaning of the law until such appreciation, as a result of a completed, a closed transaction, has been converted into cash or its equivalent, that is, has been realized as an addition to and a part of the tangible assets of the individual or corporation. An increase in value thus evidenced is intangible, unstable and is not such income as the federal income tax law contemplates shall be returned for purposes of the tax.<sup>1</sup>

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<sup>1</sup> "The courts have held, and the Internal Revenue Department has ruled, that an increase in plant accounts as a result of a revaluation of property does not constitute a profit taxable under the income tax law, whether or not such increased value is en-

tered upon the books of account. To make a taxable profit, an actual sale must take place and actual profit be made." (*Appraised Values*, booklet of The American Appraisal Company, 1919. See *Baldwin Locomotive Works vs. McCoach*, 221 Fed. 59)

## CHAPTER XII

### The Character of the Service

The preceding chapters outline the conditions under which appraisal service may be utilized in meeting federal tax requirements, but they do not serve to indicate very definitely the exact manner in which appraisals are utilized or the procedure necessary in the preparation of the highly specialized reports demanded.

It may not be amiss, therefore, to explain the broader scope and application of retrospective appraisals, and to bring this presentation of the subject to a logical conclusion by enumerating a few of the actual steps taken in the preparation of such appraisals. As a matter of accounting procedure, it is recognized that the plant accounts have been the most difficult to bring under control and to maintain in balance with the actual facts concerning the properties which they represent. The accountant, as a part of his audit, verifies the cash account against the actual cash, and the current assets and liabilities against first hand evidence; however, he can scarcely attempt to check the plant accounts against the actual plant properties, and as a consequence, his audit of these pertains more particularly to their mechanical accuracy.

The accuracy and method of maintaining the plant accounts not only directly affects the fixed assets in the balance sheet, but also includes the treatment of the



betterments, the renewals, repairs, and depreciations which have a direct bearing on the profit and loss statement. Variations in the practice of capitalizing or expensing expenditures for plant maintenance may make the difference between a profit and a loss statement.

The primary purpose of a retrospective appraisal, in distinction from a current value appraisal, is the testing of the plant accounts against the actual properties which they represent in order to provide facts to supplement the book records where for any reason these constitute inadequate evidence of the properties.

This is a desirable and necessary procedure as a part of sound business and correct accounting, quite aside from any tax requirements; and, of course, it also serves as a test of, and a basis for, the determination of the statutory invested capital, depreciation, depletion, etc. It follows naturally that corrections can come only through an analysis of the properties themselves, in direct comparison with the records which represent the property investment.

As practiced by The American Appraisal Company, therefore, the appraisal investigation comprises an analysis of the plant accounts and a test of this analysis by a personal inspection of each of the individual property units as a means of checking or determining its date of acquisition, history, expired and remaining life, condition of maintenance, changes, renewals, etc.

The analysis of the plant accounts and all other available records and information constitutes the primary basis for the allocation of the dates of acquisition and the actual costs to the property units; and it also reveals the practice followed in capitalizing expendi-

tures for plant betterments, renewals and maintenance, and the treatment of depreciation during prior years. This information, taken from the accounts, records, and the properties themselves is supplemented by an investigation of plant development and growth, the perfection of new models, the departmental development, and by personal inquiry among the operating, engineering, and executive staffs of the company. The dates of acquisition of the important units of buildings, machinery and equipment, models, and departments constitute a skeleton around which the development of auxiliary equipment must harmoniously adjust itself as do the muscles and ligaments of the human body.

It will be immediately recognized that this dependence upon the properties themselves to supply corroborative evidence is the means of bringing to light the existence of any tangible property which was not included in the capital account. Also through a careful checking of the appraisal inventory against the property records, the property in existence at the beginning of and during each of the several taxable years is identified, and the condition and remaining expectancy of life of the individual units is determined. Property units which appear in the accounts, but are not included in the inventory, are carefully investigated and disposed of in the final report in accordance with the facts determined.

The inventory as thus prepared and reconciled with the books of account is then priced in accordance with the actual costs shown by the property records, whenever such costs can be identified and allocated. Where the search for these costs is unavailing, the units are priced in accordance with the prices known to have prevailed at the dates of acquisition.

This inventory also serves as a basis for the determination of the March 1, 1913, values for properties found to have been in existence as of that date. The difference between the actual costs and the market prices as of March 1, 1913, less depreciation, represents the appreciation entering into March 1, 1913, values which is allowable in computing subsequent depreciation deductions from taxable profits.

The depreciations as of prior years, as of March 1, 1913, December 31, 1916, and the years during which the income tax laws have been in effect are determined in accordance with the existing condition of the properties (as ascertained through inspection), the expired life, renewals, and condition of maintenance (as evidenced by the accounts and the investigation), and the remaining expectancy of life.

It is evident, therefore, that the indispensable requisites of such an examination are not only carefully trained investigators, but comprehensive and authoritative cost statistics covering the prices which have prevailed in years past. No element of appreciation (or of profit when the unit was produced by plant labor) may be included in such computations, and as a consequence, the statistical data accumulated, compiled and actually used during the past for the preparation of current appraisals becomes essential in retrospective work.

After the inventory of property units has been priced and depreciated in this manner, it is itemized and summarized chronologically by years and by types of property, thus reducing the mathematical calculations for the determination of the property prices to individual property units. The costs as shown by the accounts are com-

pared with known market prices of such units at the date of acquisition to insure the correctness of the comparison with book costs and the recorded dates of acquisition, thus reducing to a minimum the opportunity for error.

The results of this detailed procedure serve to bring the plant accounts in harmony with the actual facts as evidenced by the properties themselves, furnish the necessary corrections in prior accounting practice, and serve as a basis for the maintenance of the plant and depreciation reserve accounts in the future.

ARTICLE 19, REGULATIONS 37 Revised:

Where expert appraisers are to be employed, care should be taken to see that they are men of recognized competence with respect to the particular class of property involved. In order to facilitate the acceptance of the appraisal, appraisers should be employed whose competence is well established.

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